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India 2024: Navigating Market Turbulence to Amplify Long-Term Investment Gains

Executive Summary: India's equity market, after three years of robust performance, is expected to face increased volatility in 2024. However, this turbulence is projected to be temporary, as India's structural bull market shows enduring strength. The country remains a pivotal investment destination, with investors likely to capitalize on any significant market corrections to increase their positions. This report provides an in-depth analysis of India's market dynamics and investment potential for 2024, emphasizing the nation's role as a key player in the multipolar global economy.

Key Takeaways:

- India stands as a top structural growth story among major markets.
- The economy is on track to surpass Japan, becoming the third-largest globally by 2027.
- Temporary volatility in 2024, but the long-term growth narrative remains robust.
- Investment strategy will focus on Compounders and Value Creators.

Market Analysis: Over the past three years (Nov 2020-Nov 2023), the Indian equity market has witnessed a remarkable surge, rising by 51%. This period culminated in the third quarter of 2023 (July-September), where India has delivered and impressive GDP growth at 7.6%, surpassing the anticipated consensus estimate of 6.8%. This economic upturn has been a pivotal factor in propelling the Indian Equity Market to surpass the $4 trillion market value threshold, a historic milestone that consolidates its position as the world's fifth largest in terms of market capitalization. However, Small & Midcap stocks, outperforming the Nifty index, might be approaching their cyclical peaks. The trailing 12-month P/E ratio analysis indicates:

- Nifty Index: 21.8x
- Nifty Midcap 100 Index: 31x
- Nifty Smallcap 100 Index: 23.5x (Source: Bloomberg, November 2023)

Despite the Nifty Index's forward P/E ratio of 18.8x surpassing the 10-year average, it aligns with the 63% premium over Emerging Markets (excluding China). With a 17%+ forecasted EPS CAGR over five years and strong domestic investments, these valuations are justifiable.

PEG* ratio of large economies

Countries	PE	EPS Growth (%) (CY24)	PEG Ratio
China	9.7	17.3	0.56
Taiwan	15.1	17.3	0.87
Brazil	7.3	6.9	1.06
Malaysia	13.3	12.0	1.11
India	**20.5**	**17.8**	**1.15**
Thailand	16.2	13.7	1.19
Indonesia	13.1	9.8	1.34
Mexico	10.6	7.5	1.42
Korea	11.2	7.7	1.45
US	18.3	12.2	1.50
Australia	14.6	6.0	2.44
Japan	13.6	4.4	3.10
UK	10.2	2.4	4.27

Source: Bloomberg, Jefferies Research, *MSCI Country Indices

2024 Market Volatility: Factors contributing to the anticipated market volatility in 2024 include:

1. Global economic downturn and liquidity tightening, particularly due to potential recessions in the EU and US.
2. Fluctuations in oil prices, with potential adverse macroeconomic effects if prices exceed $110 per barrel.
3. Political dynamics surrounding the 2024 elections, influencing investment sentiment.
4. Performance of US equity and debt markets, with a potential cap on returns from a US downturn.
5. Inflation surprises and the RBI's response, posing a significant volatility risk.

Temporary Nature of Volatility: Key stabilizing factors include:

- Strong macroeconomic indicators and substantial RBI forex reserves.
- Forecasted real GDP growth exceeding 6% over the coming years.
- Robust corporate earnings growth, with a 17%+ projection for 2024 and 2025.
- The transition to a middle-income nation, boosting discretionary consumption.
- Significant domestic equity flows, augmented by retirement fund investments and households' systematic investment plans.

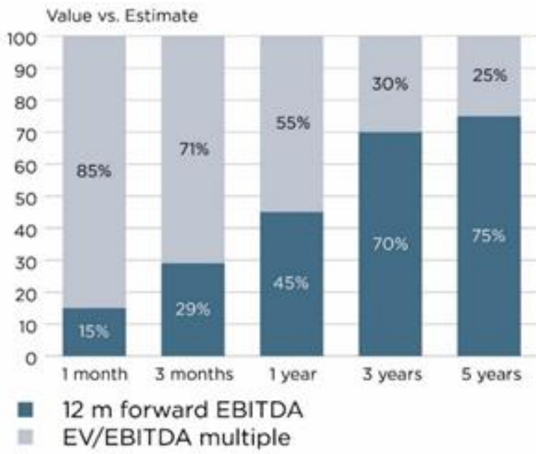
Investment Strategy: Focusing on Compounders and Value Creators:

Compounders are companies, that can deliver sustainable long-term growth. In India we like companies which can deliver sustainable EPS growth in the range of 10-20 % in the next 10 years.

Value creators are the companies, which deliver a positive spread between the Return On Invested Capital (ROIC) and the Weighted Average Cost Of Capital (WACC). That is how free cash flow for shareholders is generated. Growth creates value only when the spread is positive; it has no effect when the spread is zero and destroys value when the spread is negative.

In the context of the Indian market, it is crucial to recognize that for longer-term investment horizons, valuation becomes a less pivotal factor. This is because over longer-term periods earnings growth is the long-term driver of share prices. The earnings power of a superior business drives the bulk of the performance. We think current high valuations of Compounders and Value Creators in our portfolio should not be a major concern, as India's long-term structural story supports sustainability of growth in these companies. Timing and, therefore, valuation become less important, and the sustainability of the earnings growth becomes increasingly important for the long-term return, as seen in the chart below.

In the long term, returns are driven by earnings growth:



Source: Goldman Sachs, Datastream

High-quality compounders and value creators, despite their current high P/E ratios, are expected to sustain their high valuation multiples and outperform the market in the long term. A good example of a compounder and value creator, which traded on premium towards pees in the last 10 years would be Hindustan Unilever, a Beauty and Personal Care market leader. In the last 10 years the company demonstrated 11.2% EPS CAGR while the P/E range was 30-65, with effective PEG* above 2.5 times. The share price was up 327% (in INR) during this period.

Promising Investment Sectors:

- Domestic Cyclicals: Benefiting from sustained growth and low inflation. Our cyclical exposure is primarily through the industrials sector.
- IT and Digital Transformation: Projected 9% CAGR in technology services exports. This growth is driven by widespread technology adoption, including industrial IoT and digital, and market share gains by Indian companies, potentially doubling the direct employee headcount in the industry.
- Alternative Energy / Green Tech / Climate Change. This sector presents significant growth opportunities as the Indian government's focus on sustainable energy and technology intensifies.
- Financials: The sector is likely to outperform due to peaking short rates, higher credit growth, and low credit costs, especially benefiting non-bank lenders.
- Consumer Discretionary: Driven by favorable demographics and government policies, there is a multiyear demand surge in consumer goods.
- Automobiles, particularly Electric Vehicles: The Indian auto industry is set to benefit from low penetration, rising income levels, and the increasing need for personal mobility.
- Construction Materials: Driven by increased housing demand and infrastructure development.
- Real Estate: In metropolitan and tier 1 cities, housing demand is projected to grow 2.3x to 3x over the next decade, driven by an expanding talent pool and urban migration.

These sectors are strategically selected to leverage India's evolving economic landscape, technological advancements, and demographic shifts, aligning with our long-term investment philosophy.

Conclusion: India is poised to continue outperforming major developed and emerging markets. The combination of resilient manufacturing, rising export market share, improving current account balance, and shifting consumption patterns underlines a strong profit cycle and reduced market volatility. The investment strategy focusing on Compounders and Value Creators, with a long-term horizon, is expected to generate significant alpha and long-term outperformance.

* The PEG ratio is a measure of how expensive a stock is relative to its expected growth rate. It is calculated by dividing the price-to-earnings (P/E) ratio by the annual earnings growth rate. A lower PEG ratio means that the stock is more undervalued, while a higher PEG ratio means that the stock is more overvalued.